In the Supreme Court of the United States

OCTOBER TERM, 1940

No. 691

CHICAGO AND NORTH WESTERN RAILWAY COMPANY AND CHARLES M. THOMPSON, TRUSTEE OF THE PROPERTY OF CHICAGO AND NORTH WESTERN RAILWAY COMPANY, PETITIONERS

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the United States Board of Tax Appeals (R. 777–784) is reported in 39 B. T. A. 661. The opinion of the Circuit Court of Appeals (R. 848–859) is reported in 114 F. (2d) 882.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered July 12, 1940. (R. 860.) A petition for rehearing was denied October 18, 1940. (R.

867.) The petition for writ of certiorari was filed January 11, 1941. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether a railroad, which has consistently used the "retirement method" of depreciation accounting not only in its reports to the Interstate Commerce Commission, but also in its income tax returns, is entitled to have the "straight line" method of depreciation accounting applied retroactively as to certain structures.

STATUTES AND REGULATIONS INVOLVED

The pertinent statutes and regulations are set forth in the Appendix, *infra,* pp. 11–17.

STATEMENT

This case involves income taxes for the years 1927 and 1928. The applicable findings of fact of the Board of Tax Appeals (R. 778–780) may be stated as follows:

The Chicago & North Western Railway Company (herein called petitioner) is a railroad corporation organized under the laws of Illinois, Wisconsin, and Michigan, and is engaged in the business of common carrier for hire, with principal office at Chicago, Illinois. Petitioner's system of accounts is in accordance with the accounting regulations of the Interstate Commerce Commission,

and its income tax returns are in accordance with its accounts. (R. 778.)

In 1927 and 1928, petitioner owned five grain elevators, three coal docks, and a building in the business district of Chicago, in which its general offices were located. Its largest elevator was built at South Chicago, Illinois, in 1915 and rebuilt after an explosion which partially wrecked it in 1921. (R. 779.) The elevators and docks were constructed of reinforced concrete; they comprised 68 separate structures and 1,510 units of machinery, built or installed at various times from 1874 to 1929. (R. 779.)[1]

Petitioner has consistently carried the elevators and docks in account No. 701, "Investment in Road and Equipment," as prescribed by the Interstate Commerce Commission, and it so carried its office building until 1936, when that asset was transferred to account No. 705, "Miscellaneous Physical Property." Petitioner has never set up accounts for exhaustion, wear and tear, and obsolescence in respect of assets carried in accounts Nos. 701 and 705, but has charged to expense all expenditures for repairs, maintenance, renewals, and replacements and for cost of all assets retired, of

[1] While the petitioner's total assets in 1927 exceeded a half billion dollars (R. 253), with structures having an asserted base then of $126,290,268 (R. 599), the aggregate value of the structures here involved, for which special treatment is asked, was less than $10,000,000 (R. 593).

whatever kind, undiminished by depreciation sustained in prior accounting periods, and it has claimed and been allowed these amounts as deductions in its income tax returns, including those for 1927 and 1928, and has never sought from the Commissioner of Internal Revenue nor been granted permission to change this method of reporting. On the same basis, it has prepared its annual reports to the Interstate Commerce Commission. (R. 779.)

Its practice in this respect, in accordance with Section 7 of the Interstate Commerce Commission's "Classification of Investment in Road and Equipment," is to charge to expense any expenditure for repairs or replacements if the expenditure amounts to less than half of the value of the property as restored. If the amount is half or more of the value of the property as restored, the original cost of the property is credited to the asset account and charged to expense, and the asset account is charged with the amount of the new expenditure plus the appraised value of the retained portions of the old facility. Expenditures of less than $500 were regularly charged to expense unless a complete unit of property was replaced. Petitioner's income was reflected clearly and with reasonable consistency by the use of this method. (R. 780.)

Petitioner's books do not disclose what amounts have been charged to expense on account of replacements costing less than half the value of the property renewed, and it cannot be determined

from the entries of amounts expended whether the repairs and replacements prolonged the asset's useful life. Charges on account of all retirements, whether made to operating expense, miscellaneous rent income, or profit and loss accounts, were deducted in petitioner's income tax returns for 1927 and 1928, as in other years. Neither the books nor the returns contained any figure of annual depreciation on any of petitioner's properties. Among replacement costs charged to expense and claimed as income tax deductions were $951,821.37 and $2,114,778.81 expended in 1921 and 1922, respectively, in rebuilding the South Chicago elevator after the explosion. The Commissioner disallowed the latter amount for 1922, but did allow it for 1921 as a deductible loss sustained in the year when the explosion occurred. Similarly, the estimated or original cost of parts of the Rialto elevator, destroyed by fire in 1933, was deducted for that year. (R. 780.)

Petitioner did not enter on its books or deduct on its tax returns any amount representing depreciation on its office building, which was constructed in 1905 at a cost of $1,344,325. It charged to expense all expenditures for repairs and replacements as permitted by the regulations of the Interstate Commerce Commission, and these amounts have been deducted on its tax returns and allowed. After a protest was filed by it, however, the Commissioner allowed a deduction of $26,826.50

on account of depreciation on the building for 1927 and 1928. (R. 780.)

The Board concluded that (R. 783) for the years in question, 1927 and 1928, the petitioner should be restricted to the use of the retirement method, and disallowed depreciation deductions for the office building as well as the grain elevators and docks.[2] The court below affirmed. (R. 860.)

ARGUMENT

The court below concluded that (R. 853) the petitioner, having elected through a long period of years, including the taxable years in question, to employ the retirement method for all of its property treated as a unit, can not now claim as a matter of right the privilege of retroactively applying a different method of accounting for depreciation in respect to certain items of property for certain taxable years. The decision is correct and, in the absence of any conflict of authority, the present petition should be denied.

Under the statute, petitioner is entitled to a "reasonable allowance for the exhaustion, wear and tear of property used in the trade or business * * *." Section 234 (a) (7) of the Revenue Act of 1926 and Section 23 (k) of the Rev-

[2] A major portion of the testimony and the exhibits in the voluminous record here presented has reference to applicable rates of depreciation and obsolescence if and when allowable. Since the Board ruled that the petitioner was not entitled to apply depreciation to the tax years here in question, it was not necessary to determine what rates would be applicable.

enue Act of 1928. For many years, petitioner had employed the "retirement" method of accounting rather than the "straight line" method in computing that allowance. Either method was proper, but since petitioner kept its books in accordance with the former method, it was bound to report its income upon that basis. Section 212 (b) of the 1926 Act and Section 41 of the 1928 Act, Appendix, *infra,* p. 11. A taxpayer may change his method of accounting only by applying for permission at least 30 days before the close of the taxable period, furnishing certain detailed information to the Commissioner. Article 23 of Regulations 69 and 74, Appendix, *infra,* pp. 12–17. In view of the opportunities for eliminating entirely items of taxable income or for obtaining the same deduction twice, through a change in accounting methods, the foregoing regulations are reasonably calculated to safeguard the revenues within the authority granted to the Commissioner under the statute. Admittedly, no such application for permission to change accounting methods was filed by the petitioner, and it is therefore not entitled to have its income computed under a different system of accounting.

1. As the first reason for granting the writ, the petitioner asserts (Pet. 12) that the decision below conflicts in principle with *Northern Pac. Ry. Co.* v. *Helvering,* 83 F. (2d) 508 (C. C. A. 8th). In that case, there was no controversy over the

method of accounting employed. The problem there was simply one of proof. It was conceded that the transportation expenses of men and material in connection with new construction should be deducted from maintenance and operating expenses as a capital item. As the court there stated (p. 509): "The controversy is over the amount of such transportation expense in each of these years." The question here is not merely one of determining whether book entries are controlling as to the amount of depreciation sustained, but a much broader one, i. e., whether a large railway system which has been enjoying the benefits of the retirement method of accounting for all of its holdings can now apply retroactively the straight line method of accounting for depreciation with respect to specified structures.

2. As a second reason for granting the writ, petitioner asserts that (Pet. 13) the decision below is contrary to two decisions of this Court: *United States* v. *Ludey,* 274 U. S. 295, and *Helvering* v. *Union Pacific Co.,* 293 U. S. 282. Neither of these decisions is in point.

The *Ludey* case involved the question of basis for computing gain upon sale, and more particularly, the extent to which adjustments should be made in basis on account of prior depletion or depreciation. The Court held that the basis was to be reduced, not by the full amount of depletion or depreciation actually sustained, as contended by the Government, but rather by the amount of

depletion or depreciation allowable in the earlier years. 274 U. S. at 303–304. The limited scope of the *Ludey* case is indicated in *Burnet* v. *Thompson Oil & G. Co.*, 283 U. S. 301, 306–307.

The *Union Pacific* case has an even less direct bearing. There the taxpayer corporation had issued bonds at a discount, and sought to amortize the bond discount, as well as issuance expenses, over the life of the issue. The Court held that since the corporation employed the accrual basis of accounting, such amortization was proper.

3. Reference by the petitioner (Pet. 17–20) to *Thomson, Trustee of the property of Chicago and North Western Ry. Co.* v. *United States,* now pending in the Court of Claims, wherein the Government is contending that the basis of railway assets owned on March 1, 1913, should be diminished by depreciation sustained prior to that date, furnishes no ground for the issuance of the writ here. It will be observed that in the Court of Claims case, the Government makes no contention that depreciation subsequent to March 1, 1913, must be likewise offset. Thus, the petitioner's apprehension that the Government would improperly apply the *Ludey* decision seems unwarranted. In line with the *Ludey* decision, Section 202 (b) (2) of the Revenue Act of 1926 (*infra,* p. 11), provides, in effect, that the basis of property acquired after March 1, 1913, shall be diminished by "allowable" depreciation. Since under the retirement method of accounting followed by the railroads, no depreciation

as such is allowable for the individual items, there is no authority for reducing the basis. However, as to assets acquired prior to March 1, 1913, the same statute requires that the basis be diminished by the amount of depreciation "actually sustained before such date." In accord with this specific legislative requirement, the Government is contending in the Court of Claims case that the cost basis of assets acquired prior to March 1, 1913, must be depreciated down to that date in order to arrive at the fair market value as of March 1, 1913, the effective date of the income tax laws.

CONCLUSION

The decision below is correct. There is no conflict of authority. The Government's position in the Court of Claims case is not inconsistent with the result herein. There is no occasion for further review, and the petition should therefore be denied.

Respectfully submitted.

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